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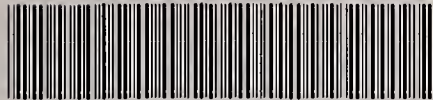
The Commonwealth of Massachusetts

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HOUSE POST AUDIT AND OVERSIGHT BUREAU

PRELIMINARY REVIEW

DOR AUDIT PRACTICES

GOVERNMENT DOCUMENTS
COLLECTION

JAN 11 1999

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Introduction

The House Post Audit and Oversight Bureau (HPAB) has conducted a preliminary review of certain operations of the Massachusetts Department of Revenue (DOR). The Bureau has reviewed budgets, records, files, reports, business plans, and memoranda of DOR, examined operations of other revenue departments and the Internal Revenue Service (IRS) and has spoken with numerous tax practitioners about current DOR administrative practices and procedures. The Bureau offers this report as an initial assessment of the problems of oversight and control over the most powerful state agency.

The Bureau commenced this inquiry after several representatives had made written requests for the Bureau to investigate claims of heavy-handed audit practices, inconsistent treatment of similarly situated taxpayers, audit assessments made without regard to DOR's statutory authority, and an internal inspections unit that was failing to carry out its stated mission and objectives.

The nature of the claims about disparate and heavy-handed treatment were serious. As a threshold matter, however, the Bureau was confronted by a substantial problem reviewing DOR. Because of the confidentiality statutes, HPAB has been unable to examine specific cases or a series of similar cases at DOR. The statutory scheme designed to protect taxpayers from unwarranted intrusions into their private affairs and to protect the system of voluntary compliance, also acts to shield DOR from scrutiny.

HPAB finds that the current provisions of Massachusetts General Laws (MGL) chapter 62C, section 21 can be used to shield DOR from outside review. DOR has, in effect, the ability to operate apart from and above any level of outside independent oversight.

Given the seriousness of the claims of disparate treatment, HPAB believes that the existing statutory scheme needs to be amended to provide for limited, but independent oversight of the agency either by the legislature, the Inspector General, or the State Auditor.

Scope

HPAB's past reviews of DOR have focused on closing district offices, management practices, the tax gap and audit productivity. This review focuses on (1) the audit division, its adherence to DOR policies and procedures, and its dealings with taxpayers and (2) the internal audit and internal affairs units, their independence from DOR administrative units, and their capacity for overseeing and monitoring DOR functions and operations.

Background

A strong, efficient and fair revenue department is critical to the operation of Massachusetts state government. Because taxes are the principal source of almost all of the funding for the Massachusetts state budget, DOR has been granted extraordinary powers to carry out its revenue assessment and collection functions.

DOR has the power to assess and *collect* taxes even before a taxpayer has had an opportunity to contest a disputed assessment. DOR can use administrative summons to compel the production of private citizens' books and records. It can impose severe financial penalties and double assess taxes for certain reporting and non-payment violations. In addition, it can bring civil contract actions to recover unpaid taxes, place liens upon private property, levy bank accounts, garnish wages, and seize private property. Given the DOR's extraordinary collection and enforcement powers, it is critical that the agency operate consistently, fairly, and equitably in its treatment of all Massachusetts citizens.

Findings

1. HPAB's multi-year review of DOR produced substantial anecdotal evidence of disparate treatment of taxpayers and inconsistent enforcement. HPAB was able to verify many of the complaints made by private citizens. However, it was unable under the existing confidentiality laws to determine whether the cases of abuse were widespread, intentional or inadvertent. HPAB found that some taxpayers were afraid to comment or make public the details of their specific cases for fear of retribution.

2. HPAB found that despite DOR's claims that it did not have quotas, the targeted production goals identified in DOR's business plans, in effect, resulted in quotas.

3. HPAB found cases where DOR continued to pursue audit and collection activities and calculate interest and penalties in contravention of case law developments.



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4. HPAB found substantial evidence that DOR's audit and enforcement personnel contributed significantly to the business tax compliance burden in Massachusetts. Specifically, HPAB found inconsistent treatment of taxpayers in the same industry, inconsistent treatment of the same taxpayer by different auditors, and extensive and irrelevant document production required of taxpayers on unrelated audit issues.

5. Frequent tax law and administrative position changes make compliance more difficult. HPAB's survey found DOR's failure to provide clear direction to taxpayers increased the compliance burden for both individuals and businesses.

6. Administrative position changes make enforcement difficult and inconsistent. HPAB found some anecdotal evidence that showed that certain taxpayer representatives were able to gain access to high level DOR officials while individuals and small businesses were relegated to the DOR's complex administrative appeals process. This discrepancy has a tendency to create substantial inequities in DOR's tax administration.

7. HPAB found anecdotal evidence that taxpayer frustration with DOR's inconsistent and complex policies, procedures and appeals process resulted in significant compliance and enforcement issues, attempts to relocate transactions and businesses to other jurisdictions, and decisions to make investments out-of-state. Business' frustration with DOR was a significant factor in several cases.

8. HPAB found evidence that long-standing defects and inefficiencies in the MASSTAX computer system contribute to DOR's inconsistent treatment of taxpayers.

The Bureau noted cases where substantial amounts of money appeared to be improperly collected from taxpayers, yet in other cases the system paid too much interest on refunds and overpayments.

9. HPAB found several high-profile non-filing tax cases which should have been detected by basic computer matches with existing computer systems. Despite DOR's claims of improved computer efficiency, HPAB discovered several instances in which individuals received state checks, reported income on state forms or received state contracts, yet failed to properly report their income or business activity to DOR. The cases the Bureau reviewed went undetected for several years.

10. HPAB's preliminary review of the top management in DOR revealed a lack of experience in several tax administration areas. Many high level officials in tax administration positions appeared to have little tax experience despite the statutory requirement to have qualifications and experience in taxation.

11. HPAB's preliminary review of offices within the Division of Inspectional Services revealed that employees of these offices face inadequate training and possible infringements on their ability to operate independently from DOR administration.

12. HPAB's preliminary review of offices within the Division of Inspectional Services further revealed that Executive Management may have abdicated or improperly delegated its role of administering DOR to offices within the Division of Inspectional Services.

13. HPAB's preliminary review of offices within the Division of Inspectional Services also revealed that offices within the Division of Inspectional Services may not

have provided sufficient independent oversight or follow-up of DOR operations to ensure that taxpayers were being treated fairly and consistently and that deficiencies that were identified were corrected.

14. HPAB's preliminary review of the actions of offices within the Division of Inspectional Services indicates that some of the reviews were incomplete and that the recommendations for remedial action failed to address the problem identified.

15. HPAB's preliminary review of offices within the Division of Inspectional Services revealed instances in which offices within the Division of Inspectional Services appeared to have interjected itself into policy-making roles reserved for other administrative units of DOR.

16. Finally, HPAB noted a change in DOR's practice with regard to Public Records Act requests during the course of its inquiry. DOR's changes had a chilling effect on taxpayers' requests for information. Given the lack of DOR regulations and policies in many areas, Public Records Act requests are one of the principal ways left for taxpayers to determine if DOR practices are consistent. HPAB became aware of specific actions, the motivation of which appeared to be that of intimidating persons attempting to make inquiries into DOR practices. House Bill No. 5244, An Act to Minimize Taxpayer Burden, filed by the Governor, proposed allowing the Commissioner of Revenue to set and impose fees relating to the administration of the tax laws of Massachusetts. Prohibitive fees imposed upon Public Records Act requests made pursuant to Chapter 66, § 10 would render the law ineffectual for taxpayers.

Survey

In April and May of 1998, HPAB sent out two mailings of a confidential survey to obtain feedback from taxpayers and practitioners about the burden of compliance that businesses confront in Massachusetts. The survey was an opportunity for taxpayers and tax practitioners to document the asserted aggressive and inconsistent positions that DOR had taken against them or their clients on audit. The survey also provided an opportunity for HPAB to review some direct evidence of DOR’s performance on audit.

Of the 200 surveys sent to taxpayers and tax practitioners, 20 were returned as undeliverable, and 42 were returned with responses within the time frame specified. The responses came from tax managers, practitioners, CPAs and several lawyers, most of whom had multiple clients. To the extent that surveys represented multiple clients, the percentages of responses may actually be understated. Each survey was treated as one response.

The survey posed 4 questions about the adequacy, efficiency, clarity, and timeliness of DOR’s audit and appeals processes. A recap of the survey responses follows. A copy of the survey is also attached.

DOR Survey Results

| | |
|-----------------|------------|
| Number Sent | <u>180</u> |
| Number Received | <u>42</u> |
| Response Rate | <u>23%</u> |

Auditors

28% of respondents had only negative evaluations of auditor's performance.

35% of respondents had only positive comments about auditor's performance.

37% of respondents had no comment or had both positive and negative comments.

Supervisors

19% of respondents had only negative comments about supervisors.

33% of respondents had only positive comments about supervisors.

48% of respondents had no comment or had both positive and negative comments.

Abatements

17% of respondents indicated that DOR took over 1 year to act on abatement claims.

7% of respondents indicated that DOR took over 2 years to act on abatement claims.

14% of respondents indicated that DOR took over 3 years to act on abatement claims.

41% of respondents had abatement claims acted on within a year.

21% of respondents did not file abatement claims or left the item blank.

Costs of Compliance

74% of respondents did not or could not quantify costs of compliance.

7% of respondents indicated that the cost was less than \$10,000.

19% of respondents indicated that the cost was greater than \$10,000.

Selected Survey Comments

- Response Survey #1 “Many notices do not indicate why there is an increase in tax. A letter to DOR does not usually elicit a response. In the course of 20 audits, I have found most of personnel at 100 Cambridge Street to be pleasant and professional.”
- Response Survey #6 “Field audit supervisors took positions that were detrimental to taxpayers based solely on dollars invested as opposed to reviewing legitimacy of taxpayers claim. DOR communication not clear. Most of information generic not specific.”
- Response Survey #12 “Workpapers contained computational errors.”
- Response Survey # 16 “DOR does not have good records about past completed audits. Constant need to send DOR documents they should already have.
- Response Survey #32 “Viewpoint of law interpretation biased in government’s favor. Most tax issues seem to be resolved in a knee-jerk reaction in DOR’s favor. DOR not as flexible as IRS --- offers in compromise.”
- Response Survey #38 “Auditor competent but pedantic. Formalistic and unimaginative and unduly concerned with minutiae. Whether from fear or direction, DOR auditors are loath to take initiative and make quick decisions. Unlike IRS agents who are far better at issue identification and determinations of materiality, DOR auditors literally reconstruct the entire period under examination from basic accounting records, i.e., sales tapes, checks, invoices, bills, etc. NIAs are cryptic at best and often wrong.”
- Response Survey #41 “It is not unusual for DOR personnel to be unaware of recent court decisions or even DOR’s own regulations Unlike many other states I have dealt with, the problems in Massachusetts seem worse as you move up the chain of command. Very often a supervisor’s only response is to ask for more documentation - an approach that is extremely costly and time consuming. Unlike other states, Massachusetts audits are so aggressive, taxpayers feel they have to hire a practitioner (lawyer or CPA) to defend them.”
- Response Survey #15 “Auditors in sales/use tend to be very sloppy. It is not unusual for auditors to take inconsistent positions on an issue with different taxpayers or even with respect to the same taxpayer for

different years. State tax administration is a difficult job. Taxpayers and practitioners have become increasingly sophisticated in recent years and a small minority tend to push the envelop in looking for loopholes. Unfortunately, DOR's response seems to have been to treat all taxpayers like tax cheats."

- Response Survey #18 "Prior audit results inconsistent with current one. Several conversations have been unable to resolve differences."
- Response Survey #27 "Taxpayers costs of compliance has not been adequately totaled. Many more hours were consumed compiling detail documentation which often resulted in minimal adjustments effecting the tax liability. Inconsistent schedules and workpapers regarding adjustment to N.O.L. carryforward."
- Response Survey #39 "In one instance, it appeared that auditor fabricated the assessment."
- Response Survey #42 "Biggest problem is inflexibility of the auditors. Issues are pushed upstairs rather than resolved at audit level."

Survey Recommendations

- Response Survey #12 "Auditors detail book should be available to all companies."
- Response Survey #38 "The IRS has concluded that a higher rate of examination coverage is better than depth of coverage. The higher the coverage the greater the compliance. The greater the depth the more adversarial examination. The greater shortcoming of DOR agents tends to be a lack of understanding of materiality with a lack of experience second. Business do not care about small items but they do care about competition."
- Response Survey #22 "DOR sales tax auditors clearly need to identify who has the burden to pay the tax liability. DOR needs to shift the burden of finding who has responsibility to collect sales tax on transactions to auditors not companies who are exempt."
- Response Survey #41 "DOR needs to do a better job pre-screening issues."
- Response Survey #27 "Adequate training of field auditors is essential. Up front planning of items to be audited must minimize burden on taxpayers."

A number of respondents also indicated that they could not understand the interest calculations made by DOR. Given the MASSTAX computer systems problems identified by HPAB in DOR's internal audit reports and other memoranda, HPAB believes that much more inquiry is warranted here.

Audit and Assessment

HPAB found repeated instances in the course of its review where DOR produced inconsistent numerical data and statistics. The variance occurred in response to different types of questions and the individual or entity asking the question. HPAB found substantial evidence that DOR used semantics and definitional distinctions to blur the reality of the results suggested by the numerical data and statistics.

HPAB found numerous cases of inconsistent reporting. For example:

- DOR counted 75 Appellate Tax Board (ATB) docket numbers as separate settlements for purposes of inflating settlement numbers even though all 75 cases were resolved as a lump sum single case settlement.
- DOR used a change in the ATB's past practice requiring multiple docket numbers for each separate tax year to the ATB's present practice of consolidating all tax years in one single appeal as evidence that a reduction in contested appeals had occurred.
- DOR included penalties assessed as part of their audit production results. The effect of this action makes waiver of penalties, no matter how justified, difficult.

- DOR manipulated the numbers of contested audit assessments and contested cases where audit assessments were ultimately overturned. The statistics generated failed to account for cases that were filed and had been appealed and in some cases failed to note that abatements had yet to be acted upon.

According to an August 12, 1997 DOR memorandum, “no formal system for tracking audit assessments exists - it is possible to use computer matches to determine which cases have eventually been abated. As a result of such reviews I can report that the percentage of audit assessments ultimately reversed is approximately 12-15%. This was determined by a review of a large sample and adding a provision for litigation losses.”

HPAB suggests that the above statement is too vague to be meaningful and, in fact, distorts reality. The period under examination was far too short to reflect all litigation losses. In many cases, litigation decisions do not become final until years after the original assessment, sometimes as long as 10-15 years (see e.g., Gillette v. Commissioner of Revenue). In addition, other assessments made on the same basis may not be abated until well after a court decision because of other contested issues or placement in the administrative process. Further, settlements of cases where the issues are simply conceded as part of the settlement under the hazards of litigation standard distort the true amount of assessments abated.

The DOR’s methodology also ignores the reality that many assessments are not appealed simply because the amount in controversy is insufficient to warrant filing a formal appeal. The Bureau’s survey had several comments which confirmed that

allegation. In the aggregate, the value of these foregone claims could be significant.

HPAB found ample survey evidence to suggest that certain dollar amount assessments were simply conceded rather than endure a lengthy and costly administrative process.

Further, the DOR's percentages are distorted because of its methodology. The number of federal change audits (where dollar values are relatively low) that are uncontested is substantial. These changes occur because the Massachusetts personal income tax laws and corporate excise conform to federal income. Any changes made to federal income as a result of final determinations by the IRS are likely to result in changes to Massachusetts income which largely go uncontested. DOR generally does not take any positive action on these cases. Individuals and corporations must report to Massachusetts when federal taxable income is determined by the IRS to be different from the taxable income originally reported. DOR's methodology of including these federal change cases depresses the percentage of "audit" cases challenged. DOR does not, as a practical matter, audit taxpayers on federal change cases. If DOR simply looked at the number of actual audits conducted by DOR field auditors which are contested and ultimately abated, the percentage of audit assessments ultimately reversed would be substantially higher.

Finally, DOR repeatedly manipulated data in response to a number of HPAB and Public Records Act requests. HPAB is troubled by the fact that DOR has the ability to present whatever numbers it chooses and then take refuge behind the confidentiality laws when questions are raised. According to the anecdotal evidence collected by HPAB, this

pattern of conduct appears to be mirrored by the audit division. It is this ultimate lack of accountability that produces the most potential for abuse by DOR.

HPAB notes that the strength of any tax administration system ultimately rests upon integrity and fairness. To the extent that disparate treatment and heavy-handedness are part of the system, voluntary compliance will suffer.

HPAB acknowledges that complex and frequent changes to tax laws present a serious challenge for audit and enforcement personnel in particular. It is, however, precisely because of this complexity that DOR regulations and directives need to be timely and clear, and that enforcement be firm, but fair. HPAB found far too many cases where the audit division simply made an assessment and forced taxpayers into the administrative appeals process rather than deal with the merits of the assessment.

DOR's practices and its statutory scheme contribute to fiscal uncertainty and significant numbers of appeals. Historically, DOR has allowed its audit division to set far-reaching, aggressive assessment policy based on novel statutory interpretations, lack of public pronouncements, or "creative" audit initiatives. Because the current system of administrative appeals requires payment before appeal (i.e., the so-called "pay to play" requirement), substantial tax and interest charges accrue and must be paid when DOR is ultimately found to have made an improper assessment by the courts. In particular, HPAB notes the following cases as historical evidence of this fact:

- Polaroid v. Commissioner of Revenue, 393 Mass. 490 (1984) - Court reversed Commissioner's statutory interpretation based upon DOR's failure to adopt any applicable regulations.
- General Electric Co. v. Commissioner of Revenue, ATB No. 113724 (1987) and

CDE, Inc. v. Commissioner of Revenue, ATB No. 113721 (1987) - Court reversed Commissioner's reporting rules despite long-standing administrative practice based upon absence of public pronouncements.

- Molesworth v. Commissioner of Revenue, 408 Mass. 580 (1987) - Court reversed Commissioner's pyramiding of interest and penalties on interest and penalties based upon lack of statutory authority.
- Towle v. Commissioner of Revenue, 397 Mass. 599 (1986) - Court reversed Commissioner's assessment policy based upon incorrect statutory interpretation.
- Perini Corp. v. Commissioner of Revenue, 419 Mass. 763 (1995) - Court reversed Commissioner's statutory interpretation because it discriminated against interstate commerce.
- Commissioner of Revenue v. Baybank Middlesex, 421 Mass. 736 (1996) - Court reversed Commissioner's assessment based upon the Commissioner's failure to follow the rules it had established via directions on an instruction sheet.

Computer Systems

HPAB found that the long-standing defects and inefficiencies in the MASSTAX computer system may affect payment allocations, assessments, calculations of interest and penalties, calculations of abatement and refund amounts, and application of credits and offsets, and write-offs. These defects at times may have caused taxpayers to be over-assessed or over-billed. Other defects may also at other times have caused DOR to collect less than it was actually owed.

The magnitude, revenue impact and legal ramifications of these defects and inefficiencies are urgent and serious problems which should have been addressed when they were originally detected many years ago. HPAB finds that DOR's failure to request and allocate sufficient resources to address these problems demonstrates a lack of oversight.

Retention and Promotion of Qualified Employees

Finally, HPAB notes DOR's continuing trend of appointing managers who do not appear to have substantive or practical tax or audit experience. The resumes of DOR managers received by HPAB reflect a lack of substantive tax or audit experience. In its review of DOR's administrative practices and procedures, HPAB noted that several DOR Chiefs and Deputy Commissioners were directly appointed to management positions without having the required tax experience.

M.G.L. chapter 14, section 1 requires that "[e]ach deputy commissioner [and] each chief of bureau . . . shall be a person of ability and experience" M.G.L. chapter 14, section 4 further states that "[a]ny person appointed to any supervisory position in the department . . . shall be a person with experience and skill in the field of taxation or in the field of the duties of such position. So far as feasible each appointment to each such position . . . shall be made by promoting an employee of the department serving in a position" HPAB suggests that DOR's failure to adhere to these legislative mandates may explain why DOR recently has had a significant problem attracting and retaining qualified and experienced employees. Further, HPAB notes that the direct appointment of potentially unqualified managers, the failure of DOR to promote qualified employees from within and the exodus of long-term DOR employees with significant tax experience has significant long term implications for the department.

Recommendations

Based upon the initial survey results and HPAB's preliminary review of DOR's internal audit reports, HPAB recommends the following:

1. A detailed inquiry be conducted into DOR's internal oversight practices and monetary accounting practices including the performance and procedures governing internal audit.
2. That the Joint Committee On Taxation hold hearings to provide an opportunity for practitioners to state their concerns about DOR practices, procedures and solutions to administrative problems.
3. Legislation should be drafted to amend the confidentiality statute to permit limited scope audits of DOR offices, bureaus and divisions by outside auditors.
4. DOR should consider establishing a system where taxpayers are notified that DOR has received returns, abatements applications and correspondence.

June, 1998

